

**LEGISLATIVE SERVICES AGENCY
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS**

200 W. Washington, Suite 301
Indianapolis, IN 46204
(317) 233-0696
<http://www.in.gov/legislative>

FISCAL IMPACT STATEMENT

LS 6208

BILL NUMBER: HB 1707

NOTE PREPARED: Jan 17, 2005

BILL AMENDED:

SUBJECT: Add back of interest and intangible expenses.

FIRST AUTHOR: Rep. Day

BILL STATUS: As Introduced

FIRST SPONSOR:

FUNDS AFFECTED: X GENERAL
X DEDICATED
FEDERAL

IMPACT: State & Local

Summary of Legislation: This bill requires a corporation, for the purposes of computing state Adjusted Gross Income Tax, to add back deductions taken on the corporation's federal income tax return for certain interest and intangible expenses incurred in a transaction with a related business. (The introduced version of this bill was prepared by the Interim Study Committee on Corporate Taxation.)

Effective Date: January 1, 2005 (retroactive).

Explanation of State Expenditures: There will be minimal cost to the Department of State Revenue to revise tax forms, instructions and computer programs.

Explanation of State Revenues: This bill's overall impact on state Corporate Adjusted Gross Income (AGI) Tax revenue is indeterminable. The requirement to add back deductions taken on the corporation's federal income tax return for certain interest and intangible expenses incurred in a transaction with a related business applies to tax years beginning January 1, 2005 and will impact revenue collections beginning in FY 2006.

Related Member Transactions: This provision requires that interest and expenses incurred in certain related member transactions, and taken as a federal income tax deduction, are to be added back to Indiana AGI. The bill could increase Corporate AGI Tax liability for the firms involved. The amount of revenue that could be captured by this provision is indeterminable. It will depend upon the number of companies conducting these types of transactions.

Primary Purpose of Avoiding Tax: The bill also gives a list of conditions that a company may show to

establish a conclusive presumption that the related member transaction did not have as its primary purpose the avoidance of tax. This provision narrows the DOR's interpretation of the allocation and apportionment provisions under IC 6-3-2-2(l). By narrowing the DOR's interpretation the bill could restrict the DOR's ability to establish taxpayer liability in some cases. Therefore, the overall impact of this provision could result in a decrease in Corporate AGI Tax revenues. By narrowing DOR's interpretation this bill could be allowing more related member transactions to be found as having a valid business purpose, and not found to be transactions conducted for tax avoidance.

Related Member Transactions (Background): A common example of a related member transaction involves the use of a passive investment company (PIC) to transfer income to a tax haven state that is actually income earned and taxable in Indiana. An Indiana operating company can establish a PIC in a state that does not have a corporate income tax (like Nevada) or that has a special income tax exemption for intangibles (like Delaware). Once the company establishes a PIC in another state, the company can then transfer income ("profits") to the PIC by having the PIC charge a royalty fee to the Indiana company for the use of a trademark, patent, or other type of intangible asset. This reduces the Indiana AGI tax liability of the operating company.

These transactions are further complicated when a PIC loans "profits" back to the operating company, and the operating company can then deduct the loan interest from Indiana AGI, thereby reducing their tax liability. Typically, large multi-state retailers engage in these sorts of transactions. Companies are not required to include payments for intangibles in Indiana Adjusted Gross Income if the company has a location in another country with a comprehensive income tax treaty with the United States.

The bill requires these intangible expenses to be added back to Indiana AGI. The bill could increase Corporate AGI Tax liability for the firms involved. The amount of revenue that could be captured by this provision is indeterminable. It will depend upon the number of companies conducting these types of transactions.

Background: In 1991, the state of Ohio passed legislation to capture income transferred through PICs for state tax purposes. The Ohio Department of Taxation's analysis of the tax returns of the 1500 largest corporations in the state estimates that including PIC income has generated \$55 M to \$60 M per year in tax revenues for the past two years. Of the 1500 corporations, 100 to 200 have PIC income. The 1500 taxpayers included in the Ohio database account for about 2/3 of the revenue from general corporations (not financial institutions).

Corporate Adjusted Gross Income Tax is deposited in the General Fund and the Property Tax Replacement Fund.

Explanation of Local Expenditures:

Explanation of Local Revenues:

State Agencies Affected: Department of State Revenue.

Local Agencies Affected:

Information Sources:

Fiscal Analyst: Adam Brown, 317-232-9854.